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Economic Report

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Commentary on Pertinent Economic Issues

Economic Forecast For 1990

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The end of a year traditionally brings forth efforts to divine the future, in order that individuals and businesses plan for the coming twelve months. The end of a decade finds people augmenting this thought process by looking back to see if any lessons can be learned which will help them see the forest for the trees. Comparing where we are today with where we were ten years ago, one finds, of course, many differences—but one important similarity, namely, prosperity.

Ten years ago, the United States economy was in the process of logging in the longest peacetime expansion in recorded history. The economy began to grow in April 1975, after 16 months of recession, and continued to expand for a record-breaking 58 months—through January 1980. That was not only twice as long as the average peacetime upswing—it was also longer than *any* other expansion recorded to date except for the 80-month upturn that encompassed World War II, and the 106-month boom that included the Vietnam War.

Not surprisingly, both business and labor shared in this advance. The jobless rate fell from a postwar high of nine percent to 5½ percent, while the number of people working rose by over 17 percent. Corporate profits, always extremely sensitive to changes in economic conditions, more than doubled over this period.

By these aggregate measures, prosperity once more reigns across the land. Last month marked the 84th month of expansion in overall economic activity—two years longer than the upswing of the late 1970s, and now the second longest in history. Unemployment is once more in the five percent zone, employment has jumped by 19 percent, while corporate profits have expanded by more than 50 percent.

To be sure, there are a number of differences, the most important of which deals with inflation. In the late 1970s, the economy was clearly overheating. Prices were soaring at double-digit rates, with both consumer and producer prices climbing by 15 percent. Interest rates were rising as the Federal Reserve tried to cool things off, but they lagged behind the rate of inflation, producing negative real interest rates, and no disincentive to borrow.

Today, inflation is much more subdued. Aside from the fact that oil prices—the major reason for the inflation of the 1970s—have come down, the economy underwent two recessions earlier in this decade, plus a number of other price-stabilizing developments (Economic Report—August 1989). And real interest rates are not only positive, but are today well above their historical norms, as the Fed has gotten out ahead of inflation by reining in the growth of money and credit.

This brings me to an evaluation of the current economic scene. In a word, it is confusing. Rare is the time when forecasting is easy, but this juncture seems more difficult than most because of the plethora of conflicting information that dots the business picture. To put it another way, there is good news and bad news out there, and the question is which—if either—will ultimately prevail.

Some Good News

Since it is fashionable nowadays to disparage the state of the economy, it might be useful to begin with the good news. Perhaps the best piece of news to come down the pike in a long time is the recent relaxation of tensions between East and West. Aside from its obvious implications for world peace, it has a significant bearing on the business outlook. For one thing, it opens up new markets for American industry. For another, it will create new investment opportunities. And, of course, it will lead to a drop in defense spending on top of that which has already occurred.

This actual and anticipated decline in defense outlays is of no small importance. First it opens up an opportunity for Washington to reduce its budget deficit by cutting spending in an area that affects only a small portion of the overall economy—yet is a big chunk of Federal spending. This alone will help to lower interest rates as Washington's borrowing requirements decline. Keep in mind also that military spending tends to be inflationary, since people are paid to produce goods that do not become available for domestic consumption, so a reduction in these outlays will also curb inflation pressures. Plainly, less inflation will also lead to lower interest rates.

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On the subject of interest rates, they have come down. Short rates are now more than two points below their spring highs, while long-term yields are off by less than 1½ points. This has reversed the negative, or inverted yield curve, in which short-term interest rates climb above long-term rates. Short rates will rise above long yields when the Fed becomes very tight with the supply of money and credit. Although not every instance of a negatively-sloped yield curve has led to a recession, every recession in at least the past 30 years has been preceded by the appearance of such an inverted curve. The curve did go negative last December, but only slightly, and has been positive, on balance, since mid-October, indicating at least a modest loosening of the Fed's grip.

One of the major unnoticed positive elements in the economic outlook is the absence of unwanted inventories. With the exception of some retailers—particularly automobile dealers—stocks throughout most of the economy appear to be in good shape. The manufacturing sector has one of its lowest ratios of inventories to sales of this decade, while wholesalers' stocks are well below recession highs. Credit the widespread use of computers, just-in-time inventory management, and a willingness to reduce orders and output at the first sign of sluggishness with keeping inventories down. In turn, this should help the economy avoid the shock that massive inventory liquidation usually brings.

Another plus is the high level of employment. Thanks to the growing number of jobs in the service sector, total employment is at a record level and the jobless rate is very close to its low point for the cycle. More jobs obviously produce more confidence—not to mention more buying power, so although consumer spending is not booming, it is still climbing even after subtracting the effects of inflation.

Speaking of increased spending, it is impossible to ignore the huge orders placed for aircraft by the world's airlines over the past two years. The major U.S. aircraft producers, Boeing and McDonnell Douglas, have enough planes on order to keep their assembly lines—and those of their suppliers—humming for years. Besides helping local economies, this influx of orders offers an opportunity for many defense contractors and sub-contractors to keep their assembly lines humming—if they can make the transition from military to civilian methods of production and cost control.

This is not to suggest that there will not be much government work in the offing. On the contrary, the need to rebuild the nation's highways, bridges, tunnels and other public facilities has been obvious for some time—and is already being tackled, judging by the amount of construction one encounters as one travels around the country. Add to this the expected infusion of Federal money to help the Southeast repair the damage caused by Hurricane Hugo, and the West Coast rebuild from the earthquake, and you have plenty of business for the nation's construction firms. Let's not forget also the ongoing efforts to clean up the environment by curbing pollution and recycling waste, as an added source of business.

Some Bad News

To be sure, there are some negatives as well. New domestic car sales rose 6½ percent in 1988, reaching 7½ million units. After a shaky start, they moved higher this year, reaching an 8⅓ million unit clip by August. However, that was fueled by deep discounts and the threat of a big price increase on the 1990s; sales fell in September and October, and by early November reached one of the lowest selling rates since the 1981-82 recession. Detroit has responded by slashing production schedules and laying off workers.

Homebuilding has been declining for a longer period of time, indicating deeper-rooted problems. Although new-home starts rose during the mid-1980s from their recession lows, they have since fallen back and are currently no higher than levels first reached almost 40 years ago. The reasons are many, but they include high interest rates, prices that have gone up much faster than family incomes, and in-

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	< Actual			Projected >
	1989			
	1	2	3	4
Gross National Product	5113.1	5201.7	5278.9	5325.8
GNP: $82	4106.8	4132.5	4160.2	4157.5
% Change, Annual Rates	3.7	2.5	2.7	-0.3
Consumption $82	2641.0	2653.7	2694.1	2670.7
Durables $82	419.3	424.9	438.3	411.1
Non-Durables $82	915.0	909.7	922.5	924.1
Services $82	1306.7	1319.0	1333.3	1335.5
Investment $82	721.1	719.8	723.6	739.1
Non-Residential $82	501.0	511.4	517.2	514.4
Producers Durable Equip. $82	379.9	393.2	397.5	394.8
Structures $82	121.1	118.1	119.7	119.5
Residential $82	195.6	189.3	185.2	189.2
Inventory Changes $82	24.5	19.1	21.2	35.6
Net Exports $82	-55.0	-51.2	-63.6	-68.5
Exports $82	569.7	587.5	589.8	586.1
Imports $82	624.6	638.7	653.4	654.6
Government Purchases $82	799.7	810.3	806.0	816.3
Federal Defense $82	254.4	255.8	260.4	254.5
Federal Civilian $82	81.1	87.8	76.1	90.9
State & Local $82	464.2	466.7	469.4	470.9
Final Sales: $82	4082.3	4113.4	4139.0	4122.0
% Change, Annual Rates	3.1	3.1	2.5	-1.6
Domestic Demand: $82	4161.8	4183.7	4223.8	4226.0
% Change, Annual Rates	1.8	2.1	3.9	0.2
Final Dom. Private Demand $82	3337.6	3354.3	3396.6	3374.2
% Change, Annual Rates	2.3	2.0	5.1	-2.6
GNP Price Index (1982 = 100)	124.5	125.9	126.9	128.1
% Change, Annual Rates	4.0	4.6	3.2	3.8
Consumer Price Index (82-84 = 100)	121.9	123.8	124.6	125.5
% Change, Annual Rates	5.4	6.4	2.4	3.0
Total Personal Income	4317.8	4400.3	4457.5	4528.5
Disposable Personal Income	3689.5	3747.7	3808.4	3864.1
Savings Rate	5.6	5.3	5.0	5.7
Unemployment Rate	5.2	5.3	5.2	5.5
Indus. Production (1977 = 100)	140.7	141.7	142.2	141.9
Housing Starts (000)	1517.3	1352.0	1339.0	1322.7
Domestic Auto Sales (000)	6915.0	7327.7	7867.7	6060.4
Dom. Auto & Lt. Truck Sales (000)	11523.0	11982.8	12767.7	10860.4
Corporate Pre-Tax Profits	318.0	296.0	272.0	250.2
Net Profits	173.6	161.1	149.5	138.1
Net Cash Flow	388.6	391.7	396.7	366.2

creased restrictions imposed by localities on developers.

When housing suffers, many other industries do, too. Besides reduced demand for labor and construction materials, fewer homes built mean fewer sales of household furnishings, such as furniture, fixtures and home appliances. In turn, this tends to hold back consumer spending in general, since people are less apt to be in stores. You can see where the ripple effect here is even greater than with automobiles.

Turning to foreign trade, exports stopped growing around midyear, sending the trade deficit soaring in the third quarter, as measured in the GNP accounts. On a monthly basis, the trade deficit in September retreated to its lowest level in nearly five years—but mainly because of a drop in imports. With the dollar well above its early 1988 lows (and overvalued against many currencies), it is fairly obvious that the decline in imports is more a sign of greater domestic weakness, than of increased domestic competitiveness.

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ed Annual Rates)
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YEAR 1989		1990				YEAR 1990	
LEVEL	% CH	1	2	3	4	LEVEL	% CH
229.9	7.2	5364.8	5407.1	5460.2	5530.1	5440.6	4.0
139.3	2.9	4152.3	4152.9	4158.6	4176.8	4160.2	0.5
2.9		-0.5	0.1	0.6	1.8	0.5	
664.9	2.6	2679.1	2693.5	2702.5	2718.3	2698.3	1.3
423.4	2.4	411.4	413.6	415.2	419.6	415.0	-2.0
917.8	1.5	927.0	930.2	933.2	937.5	932.0	1.5
323.6	3.4	1340.7	1349.7	1354.0	1361.2	1351.4	2.1
725.9	1.4	716.4	706.7	702.7	703.0	707.2	-2.6
511.0	3.5	508.0	502.6	497.0	493.1	500.2	-2.1
391.4	5.3	390.2	387.2	383.0	379.8	385.0	-1.6
119.6	-2.1	117.8	115.4	114.0	113.3	115.1	-3.7
189.8	-2.2	184.8	182.9	183.6	189.3	185.2	-2.4
25.1		23.5	21.2	22.1	20.6	21.9	
-59.6		-60.4	-65.5	-69.3	-70.7	-66.5	
583.3	10.0	580.3	575.0	573.9	579.1	577.1	-1.1
642.8	6.3	640.7	640.6	643.2	649.8	643.6	0.1
808.1	2.9	817.3	818.2	822.7	826.2	821.1	1.6
256.3	-2.0	252.4	246.5	244.2	238.8	245.5	-4.2
84.0	24.6	91.1	94.6	96.6	97.4	94.9	13.0
467.8	2.5	473.9	477.2	482.0	490.0	480.7	2.8
114.2	2.9	4128.8	4131.7	4136.5	4156.2	4138.3	0.6
2.9		0.7	0.3	0.5	1.9	0.6	
198.8	2.4	4212.7	4218.4	4227.9	4247.5	4226.6	0.7
2.4		-1.3	0.5	0.9	1.9	0.7	
365.7	2.4	3371.9	3379.0	3383.1	3400.7	3383.7	0.5
2.4		-0.3	0.8	0.5	2.1	0.5	
126.3	4.2	129.2	130.2	131.3	132.4	130.8	3.5
4.2		3.5	3.1	3.4	3.4	3.5	
124.0	4.7	126.4	127.3	128.3	129.6	127.9	3.2
4.7		3.0	3.0	3.1	4.0	3.2	
426.0	8.9	4578.4	4636.5	4689.7	4764.2	4667.2	5.4
777.4	8.6	3904.4	3955.3	4001.6	4065.3	3981.7	5.4
5.4		5.4	5.1	5.0	5.0	5.1	
5.3		5.9	6.1	6.3	6.4	6.2	
141.6	3.2	140.5	140.1	139.8	140.5	140.2	-1.0
382.8	-7.5	1217.7	1247.4	1366.0	1416.1	1311.8	-5.1
042.7	-6.7	5949.4	5848.3	5896.3	6094.2	5947.0	-15.6
783.5	-5.2	10749.4	10548.3	10596.3	10894.2	10697.0	-9.2
284.0	-7.4	225.4	225.4	230.1	250.3	232.8	-18.0
155.6	-7.9	124.2	124.2	127.2	138.1	128.4	-17.5
385.8	-4.0	328.2	328.5	336.6	363.8	339.3	-12.1

You will recall I pointed out before that service employment has helped keep total employment up. The flip side of this is that employment in the goods-producing industries—especially in manufacturing—has begun to decline. Indeed, factory payrolls fell for seven months in a row between March and October. Output of goods is now falling; the Federal Reserve's index of industrial production is down over the past three months—the first such decline in more than three years. Even production of business equipment, previously a bright spot, stopped expanding around midyear; it has fallen in three of the past four months and now stands at its lowest level since February.

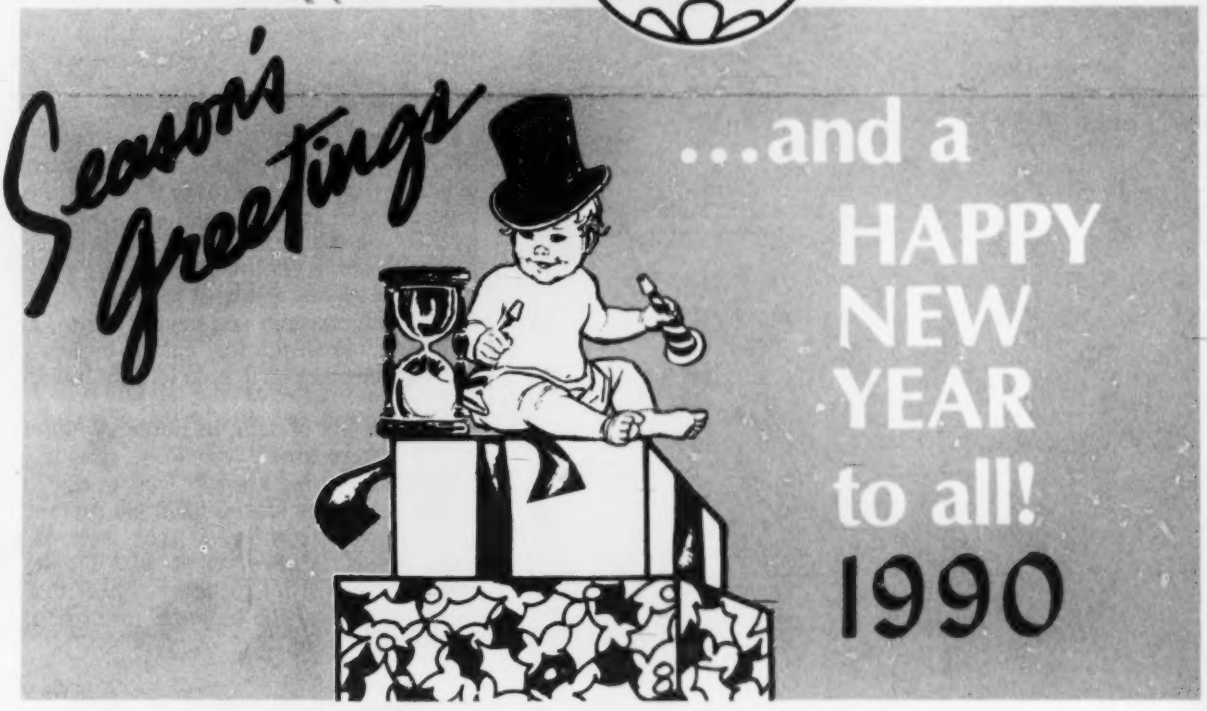
One reason for this drop might be the decline in corporate profits registered so far this year. It obviously reflects the softness in many segments of the economy, which is preventing businesses from generating enough unit volume to boost profits—not to mention keeping them from passing along higher costs in the form of higher prices. Lower profits mean less money available to spend on new machinery and equipment, research and development—and, of course, additions to the workforce. Fal'ing profits also make it more difficult for business to bear its debt burden.

On the subject of debt, its burden would be lighter if interest rates were lower. And while rates have come down, as noted above, they are still high in real terms, as was also pointed out. One reason might be that the Fed is still being comparatively tight-fisted. Bank reserves have been falling all this year, as have the broader measures of the money supply, adjusted for inflation. These developments in the past have pushed the economy into recession because of inadequate liquidity.

It's Up To The Fed

At this point, the pluses are in the process of being outweighed by the minuses. To prevent this from becoming a full-fledged slump, the Fed will have to ease further, allowing the money supply to grow, and interest rates to fall. If nothing else, this is needed to keep the stock market from tumbling. Although the events that took place on Friday, October 13 were not precisely anticipated, the October issue of this Report did conclude with a warning that stocks were vulnerable to a decline. That they fell as swiftly as they did on the 13th, and on one or two days afterward, is a signal that the Fed should not overlook: The market is reflecting increasingly deteriorating economic conditions.

Managing the economy has been almost exclusively the province of monetary policy since the beginning of this decade. The fast-moving events in Eastern Europe now provide room for fiscal policy to help via cuts in defense spending. In turn, this should give the Fed confidence that it can ease without triggering a new round of inflation. On the assumption that the Fed will ease, our economic forecast for 1990, presented in the table to the left, calls for a pause in the expansion—but no full-blown recession. ■



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